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to:

Team Leader

International Examiner

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Special Trial Attorney

subject: REIT Shelter

LEGEND

REIT-CO =

Class A Shareholder =

Parent =

Bank =

Real Holdings =

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Promoter	=
Year 1	=
Year 5	=
Year 6	=
Year 9	=
Year 18	=
Year 19	=
Year 20	=
Year 21	=
Year 65	=
Year 66	=
Month 1	=
Date 2	=
Date 3	=
Month 4	=
Month 5	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Previous Submission	=
Tax Advisor	=
<u>a</u>	=

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b =c =d =e =f =g =h =i =j =k =l =m =n =o =p =q =r =s =t =u =v =w =x =

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<u>y</u>	=
<u>z</u>	=
<u>aa</u>	=
<u>bb</u>	=
<u>cc</u>	=
<u>dd</u>	=
<u>ee</u>	=
<u>ff</u>	=
<u>gg</u>	=
<u>hh</u>	=
<u>ii</u>	=
<u>jj</u>	=
<u>kk</u>	=
<u>ll</u>	=

ISSUE

Whether REIT-CO is entitled to a deduction for dividends paid (“DPD”) with regard to the purported consent dividends declared by REIT-CO to the Class A Shareholder

CONCLUSION

Because the Class A Shareholder is not entitled to and will never receive the economic benefit of amounts for which it has executed consents, the putative consent dividends declared by REIT-CO are shams. The declaration of such dividends in excess of the actual dividend rights of the Class A Preferred Stock results in the treatment of the putative consent dividends as preferential dividends. Preferential dividends are not treated as consent dividends, and a DPD is not allowed with regard to

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such amounts. Because REIT-CO is not entitled to a DPD for such amounts, REIT-CO fails to meet the requirements of section 857(a)(1)(A) for taxable years at issue.

FACTS

I. Background

Parent is a bank holding company and the parent of a group of affiliated corporations (the “Parent Group”). For all relevant tax years, Parent Group filed consolidated Federal income tax returns. Parent Group provides banking and other financial services in several states. Bank is a wholly-owned subsidiary of Parent. Real Holdings, a wholly-owned subsidiary of Bank, is engaged in the business of acquiring, holding, and selling interests in real property, corporations and entities. Bank and Real Holdings are members of Parent Group.

REIT-CO was incorporated in Year 1 as a subsidiary of Real Holding, for the purpose of acquiring, holding, and selling interests in real property belonging to the Parent Group. From its inception, REIT-CO elected to be taxed as a real estate investment trust (“REIT”) under sections 856-860 of the Internal Revenue Code of 1986 (the “Code”). REIT-CO is not a member of Parent Group.

Prior to the Recapitalization at issue, REIT-CO had issued and outstanding: (1) d classes of preferred stock with fixed dividends rights and relatively de minimis value (together, the “Senior Preferred Stock”); and (2) a shares of Common stock, with b shares held by Real Holdings and c held by Parent.

II. Promoter

In Month 1, Year 5, representatives of Promoter met with Parent to propose a REIT recapitalization involving a \$j investment in REIT-CO by a tax-neutral foreign investor, in exchange for new Class A preferred stock. The foreign investor would agree to receive large consent dividends. The Parent Group would exchange its old common stock for Class B common stock. The financial analysis and economic projections provided assumed that, prior to scheduled liquidation, Parent would exercise an option to acquire the new class of stock from the foreign investor, or that the foreign investor would exercise a put option to compel Parent Group to acquire the new class of stock.

The Promoter’s analysis assumes that, every year, after payment of dividends to the Senior Preferred shareholders, cash dividends would be paid in the amounts of \$k on the Class B stock, and \$i on the Class A stock. The remaining income would be “allocated” to the Class A shares.

On the factual assumption that the “Average blended portfolio earnings rate” of REIT-CO would be m% annually, the analysis forecasted that a total of \$n would be

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allocated to the foreign investor by Month 5, Year 20, but that the earnings that it would actually receive would be approximately \$0, which is approximately 6 percent of the amount allocated. The amount of actual earnings received would include (1) cash dividends received to Month 5, Year 20 and (2) additional earnings included in the "Buyout Amount," which would be received by foreign investor on the exercise of an option to terminate the structuring in Year 20. On these facts, the analysis concluded that the foreign investor's annual return on investment would be s% at the exercise of the option.

The analysis further projects that the Class B shareholders would be allocated approximately \$t of REIT-CO's income, but that the class B stock's true economic share of earnings would be approximately \$u, which is almost quadruple the allocated amount. Assuming that the structuring unwinds in Month 5, Year 20, the analysis anticipates that the structuring would have a "Marginal After Tax Present Value Benefit" to the Parent Group of approximately \$y. The estimated marginal reduction of Federal income tax liability was estimated at \$x for taxable Year 5 and \$y for taxable Year 6, the years at issue herein.

Following the presentation, on or about Date 2, Year 5, Parent formally engaged Promoter to act as advisor regarding the structuring and completion of REIT Recapitalization. In exchange for these services, Parent agreed to make \$w in incremental payments to Promoter from the closing date of the transaction until Date 3, Year 9. These payments equal almost 30 percent of the initial capital raised from the Recapitalization.

During Month 4, Year 5, Promoter made a presentation to Class A Shareholder regarding the possibility of acquiring participating preferred stock in REIT-CO. Class A Shareholder is a qualified international organization under Section 892(b) of the Code. Thus, Class A Shareholder is exempt from taxation in the United States with respect to its earnings from investments in U.S. stock, bonds, or domestic securities.

On Date 9, Year 5, Promoter presented a detailed outline of the terms and conditions relating to the proposed Recapitalization. Under the proposal, the Class A Shareholder would agree to purchase a new class of REIT-CO participating preferred stock, which, under the governing documents, would be entitled to any distribution of earnings made by REIT-CO after payment of cash dividends. However, Class A Shareholder would agree to cause the unpaid earnings to be reinvested in REIT-CO during the period extending from the date of the Recapitalization through the end of Year 18. This period was referred to in the Promoter materials as the "Accumulation Phase." During the following period, referred to as the "Distribution Phase", Class A Shareholder's dividend rights would be limited to approximately d% of the earnings of REIT-CO; the remainder would belong to the common shareholders. As a result, the foreign investor would postpone recovery of the reinvested earnings until REIT-CO was liquidated in Year 66, subject to the exercise of options beginning in Year 20.

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The Promoter materials state that the minimum return to be expected to the Class A Shareholder would be kk%, due to built-in protections in the appraisal procedures. Further, the materials provide that the projected yield to the Class A Shareholder would fall into the range of ll%.

III. Tax Advisor

In a memorandum of Date 10, Year 5, Tax Advisor described the transaction proposed by Promoter as follows:

The plain [sic] english of all this, ignoring the senior preferred, is that * * * [in Year 6 through Year 18], Class B gets z% of the issue price, Class A gets a fixed dollar amount and the rest of the taxable income is a consent dividend. In [Year 19 through Year 65], all the taxable income is paid out, aa% to Class B, z% to class A. In Year 66, the REIT liquidates and both Class A and B get repaid their initial investment and Class A gets the remainder. Assuming that all taxable income was paid out, the amount left after repayment of the issue price of the A and B will be the sum of the consent dividends made by Class A in [Year 5 through Year 18]. It will not have increased in value because all of the earnings in [Year 19 through Year 65] will have been paid out.

It is not expected, however, that the REIT will continue to exist until it is liquidated in Year 66. The Option Agreement contains a buy/sell feature. * * * The price to be paid if either of these options is exercised is set in the Option Agreement. It is the sum of the following: 1) the present value of the dividend payments that the Class A shareholders will receive between the date of the purchase or sale and Year 66, 2) the present value of the right to the return of the issue price of the Class A stock at liquidation, and 3) the present value of the remaining liquidating distributions that the Class A shareholders can expect to receive in Year 66. . . . Based on examples supplied by Promoter, the purchase price of the shares in Year 20 assuming a constant average yield of m percent would be about \$r. This breaks down to be \$bb for present value of the dividend stream and the return of the issue price and \$cc for the liquidation rights in excess of the issue price.

IV. The Recapitalization

Parent Group, REIT-CO, and Class A Shareholder entered into the transaction proposed by Promoter. The governing terms are contained in multiple documents, including the Articles of Restatement of Articles of Incorporation ("Articles") and the Stockholders Agreement, both dated Date 3, Year 5.

REIT-CO amended its Articles consistent with the arrangement outlined in the Promoter presentations. The Senior Preferred Stock remained in place and maintained its preference over other classes. Beyond that, Class A Shareholder contributed \$j in exchange for all shares of new Class A Participating Preferred Stock ("Class A

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Preferred Stock”), and Bank and Real Holdings exchanged all of their common stock for all of the shares of new Class B Stock. Real Holdings held h% of the Class B Stock and, therefore, is referred to as “Class B Shareholder” (together with Bank, “Class B Shareholders”).

A. Dividend Rights

After the payment of relatively de minimis dividends on the Senior Preferred Stock, the holders of Class A Preferred Stock and Class B Stock are entitled to distributions. Dividend rights under the controlling documents are different, depending upon whether such distributions occur on payment dates through Year 18 (during the Accumulation Phase) or beginning thereafter (during the Distribution Phase). These dividend rights correspond very closely to those laid out in the Promoter presentations and described by Tax Advisor.

The Articles provide that, on each dividend payment date during the Accumulation Phase, the Class B Shareholders are entitled to cumulative cash dividends in the amount of \$ddd (“Class B Preferred Dividend”). Following payment of the Class B Preferred Dividend, dividends may be declared by REIT-CO only on the Class A Preferred Stock. Under the Stockholders Agreement, the Class A Preferred Stock is guaranteed a cash dividend of \$eee (“Class A Minimum Dividend”). Further, the Class A Shareholder agreed with respect to each taxable year during the Accumulation Phase, to execute a consent in accordance with section 565 of the Code to receive any declared dividends in excess of the Class A Minimum Dividend as consent dividends. The Class A Minimum Dividend alone provides to the Class A Shareholder a return of p% on its initial investment.

During the Distribution Phase, the Senior Preferred Shareholders continue to be entitled to their fixed preferred dividends, and the Class B Shareholder continues to be entitled to its Class B Preferred Dividend. However, following payment of those amounts, the remaining earnings for the year will be allocated ff% to the holders of Class B stock (Class B Entitlement) and gg% to the Class A Preferred stock (Class A Entitlement). If the Class A Entitlement is less than the Class A Minimum Dividend, then the Class A Shareholders will receive the Class A Minimum Dividend. Thus, following the Accumulation Phase, the Class B Shareholders essentially return to their pre-Recapitalization dominion over the residual earnings of REIT-CO.

The Stockholders Agreement provides that “no distribution shall be made by [REIT-CO] if such distribution would give rise to a ‘preferential dividend’ within the meaning of Section 562(c) of the Code.”

B. Liquidation Rights

Under the Articles, REIT-CO will be liquidated in Year 66. After payment of dividends and liquidation preferences on Senior Preferred Stock, liquidating distributions

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will be made as follows: First, the Class A Shareholder is entitled to an amount equal to the issue price of its stock (Class A Liquidation Preference). Next, Class B Shareholders are entitled to an amount equal to the issue price of their stock (Class B Liquidation Preference). Finally, the Class A Shareholder is entitled to the remaining assets of REIT-CO. Because all earnings are to be currently distributed during the Distribution Period, the assets received by the Class A Shareholder will consist of the pool of consent dividends declared throughout the Accumulation Period, without further earnings or growth.

C. Purchase and Sale Options

1. Scheduled Options

Under the Stockholders Agreement, Class A Shareholder has the option to sell all, but not less than all, of its Class A Preferred Stock to Class B Shareholder on the first business day of Month 5, Year 20, and every third year thereafter ("Scheduled Sale Option"). Similarly, Class B Shareholder holds an option to purchase from Class A Shareholder all, but not less than all, of the Class A Preferred stock, on the first business day of Month 5, Year 21 and each successive third year thereafter. ("Scheduled Purchase Option" and, together with the Scheduled Sale Option, the "Scheduled Options"). Under either of the Scheduled Options, the exercise price will be equal to the then "Fair Market Value" of such stock, determined in accordance with certain appraisal procedures.

Under the Stockholders Agreement, "Fair Market Value" is defined, in pertinent part, as the sum of the "Fair Expectation Value" and the "Fair Liquidation Value." Fair Expectation Value means the sum of the then-present value of dividends projected to be declared on the Class A Preferred Stock from the Scheduled Option exercise date through the Year 66 liquidation date, plus return of the issue price of the Class A Preferred Stock. Under this formula, the stream of cash dividends expected through the liquidation date, which approximate \$ee annually, will be added to the \$j issue price of the Class A Preferred Stock, and discounted to present value using a discount rate equal to the market rate of return for assets similar to those held by REIT-CO.

Fair Liquidation Excess Value is computed under a formula that entails discounting projected liquidating distributions for Class A Preferred Stock that exceed the Class A issue price. Because an assumption underlying the calculation is that all current earnings are distributed during the Distribution Phase, the amount of this portion of the liquidating distribution would equal the pool of consent dividends declared during the Accumulation Phase, without further earnings. This amount will be discounted using a discount rate that is e basis points higher than that used in determining Fair Expectation Value.

2. Unscheduled Options

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Class A Shareholder holds an option to sell all, but not less than all, of its Class A Preferred Stock to Class B Shareholder on the occurrence of any of a number of events ("Unscheduled Sale Option"). These events include: (1) REIT-CO's failure to pay dividends, (2) REIT-CO's bankruptcy; (3) REIT-CO's incurring or assuming significant debt, or conduct of unauthorized business activities; (4) REIT-CO's failure to qualify as a REIT for Federal tax purposes; (5) a change in the law adversely affecting the availability or utility of any remedy available to Foreign Investor vis-à-vis the Class B Shareholders, or (6) a reduction in the book value of the assets of REIT-CO below \$hh.

In addition, Class B Shareholder holds an option to purchase the Class A Preferred Stock at any time following the occurrence of any of certain events ("Unscheduled Purchase Option", together with the Unscheduled Sale Option, the "Unscheduled Options"). These events include: (a) an Adverse Law Change, which includes a determination by the Service, Treasury, or any court that the expected tax benefits from the Restructuring will be disallowed; and (b) a downgrade of the Bank's rating to lower than BBB by Standard & Poor's or Baa2 by Moody's.

The price to be paid on the exercise of any Unscheduled Option depends on the date of the occurrence of the event that triggered the availability of the Unscheduled Option. If the event occurs after Date 7, Year 20, then the Class A Shareholder will receive the Scheduled Option Purchase Price, which equals the Fair Market Value, discussed above. However, if the event occurs on or before Date 7, Year 20, then the Class A Shareholder will receive the Unscheduled Option Purchase Price. The Unscheduled Option Purchase Price equals the issue price of the Class A shares, plus any Class A Minimum Dividends that are in arrears, plus Fair Liquidation Excess Value, as defined above, but computed using a discount rate multiplied by an adjustment factor.

Under the Stockholders Agreement, REIT-CO and Bank have each guaranteed Class B Shareholder's obligation to pay the purchase price on a duly exercised Scheduled or Unscheduled Option. Further, Class B Shareholder has pledged Class B Stock having an initial aggregate issue price of \$hh to secure its obligation to purchase the Class A Stock under the Scheduled and Unscheduled Sale Options.

3. REIT-CO Option

REIT-CO holds an option to purchase from Class A Shareholder all, but not less than all, the Class A Stock at any time following a Class A Stockholder Breach Event, which includes failure by Class A Shareholder to execute required consents to accept consent dividends in lieu of cash dividends from REIT-CO ("REIT-CO Option"). The Class A Stockholder Breach Purchase Price is computed, in pertinent part, as 99% of the issue price of the Class A Preferred Shares, plus any Class A Minimum Dividends that are in arrears, plus a pro rata portion of the next scheduled Class A Minimum Dividend. Any damages incurred or reasonably expected by REIT-CO as a result of the breach will be subtracted from the payment.

D. Transferability of Class A Preferred Stock

Under the Stockholders Agreement, REIT-CO and Class B Shareholder may bar any transfer by Class A Shareholder of shares of Class A stock which would result in a material risk of adverse tax consequences for REIT-CO or any of its direct or indirect stockholders. Any transferee of Class A stock becomes a party of the Stockholders Agreement and takes such shares subject to the Scheduled and Unscheduled Options, the REIT-CO Option, and all other limitations imposed under the Stockholders Agreement.

E. Business Purpose

REIT-CO asserts that it entered into the Recapitalization for the purpose of raising \$j in regulatory capital. As REIT-CO has explained in its Previous Submission, the initial investment purportedly constitutes Tier II capital. In the same document, REIT-CO has stated that its Tier I capital will be annually increased by the amount of the consent dividend less the portion representing the present value of Class A Shareholder's rights to the paid in capital upon the liquidation of REIT-CO in Year 66.

V. Consent Dividends Declared in Year at Issue

For taxable years ended Date 8, Year 5, and Date 8, Year 6, REIT-CO declared consent dividends with respect to the Class A Preferred Stock of \$ij and \$jj, respectively. If respected, these declarations would constitute an annual return of more than i% on the initial investment of the Class A Shareholder. However, REIT-CO has conceded in its Previous Submission that the Class A Shareholder's expected annual yield on its investment would range from f% if the stock were held until liquidation to g% if an option were exercised in Year 20.

LAW

I. REIT Qualification and Consent Dividend Provisions

To qualify as a REIT, a corporation must satisfy the organizational, operational, and distribution requirements of sections 856 and 857. Under section 857(a)(1)(A), a corporation will not qualify as a REIT for a taxable year unless it receives a deduction for dividends paid that meets a certain threshold in that year.

Section 561(a) provides that the deduction for dividends paid includes the sum of (i) dividends paid during the taxable year, and (ii) the consent dividends for the taxable year (determined under section 565).

Section 565 provides that, if a shareholder holds consent stock on the last day of a corporation's taxable year and such person agrees in a consent filed with the return of

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the corporation to treat as a dividend the amount specified in the consent, the amount specified will constitute a consent dividend, except as provided in section 565(b).

Section 565(b) provides that a consent dividend shall not include an amount which if distributed in money would constitute a preferential dividend under section 562(c).

Section 562(c) defines a preferential dividend to include any distribution made with preference to one class of stock as compared to another class, except to the extent that the former class is entitled to such preference without reference to waivers of their rights by shareholders.

Section 1.565-2(b)(i) provides that a preferential dividend is an actual distribution, a consent distribution, or a combination of the two, which involves a preference to one or more shares of stock as compared with other shares of the same class or to one class of stock as compared to another class of stock.

Section 1.562-2(a) provides that, to avoid preferential dividend treatment, no class of stock may be treated otherwise than in accordance with its dividend rights as a class. The existence of a preference is sufficient to prohibit the deduction for dividends paid “regardless of the fact * * * that such preference is authorized by all the shareholders of the corporation.” Further, the regulation provides that the disallowance of the deduction for dividends paid extends to the entire amount of the distribution, and not merely to a part of the distribution.

Section 565(f)(1) defines “consent stock” as the class or classes of stock entitled, after payment of preferred dividends, to a share in the distribution (other than in complete or partial liquidation) within the taxable year of all the remaining earnings and profits, which share constitutes the same proportion of such distribution regardless of the amount of such distribution.

Section 1.565-2(a) provides that amounts specified in consents filed by shareholders are not treated as consent dividends to the extent that they would constitute a preferential dividend. If any portion of any amount specified in a consent dividend is not treated as a consent dividend under section 565(b) and this section of the regulations, it is disregarded for tax purposes.

Section 1.565-2(b)(2), example (3), illustrates the treatment of a preferential distribution. In the example, Corporation Z, a calendar year taxpayer, has two classes of stock outstanding, Class A and Class B, each of which is consent stock and consisting of 500 shares. The Class A stock is entitled to 2/3 and the Class B is entitled to 1/3 of any distribution of earnings and profits. On December 15, Corporation Z distributes on the Class B stock \$2 per share or \$1000 and the shareholders of the Class A stock consent to include in gross income amounts equal to \$2 per share or \$1000. The example holds that the entire distribution of \$2000 is preferential, in that the

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Class B stock received more than its pro-rata share of the combined amounts of the actual and the consent dividends. Thus, the entire dividend is disregarded.

Section 565(c) provides that the amount of a consent dividend shall be considered (1) as distributed in money by the corporation to the shareholder on the last day of the taxable year of the corporation, and (2) as contributed to the capital of the corporation by the shareholder on such day.

II. Sham Transaction and Substance over Form

Courts have consistently looked to the objective economic realities of a transaction rather than to the particular form the parties employed. Boulware v. United States, 128 S. Ct. 1168, 1175 (2008) (citing Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978)). Courts do not recognize the “simple expedient of drawing up papers” as controlling for tax purposes when the objective economic realities are to the contrary. Commissioner v. Tower, 327 U.S. 280, 291 (1946). “[T]he law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality.” Coltec Indus. v. United States, 454 F.3d 1340, 1352 (Fed. Cir. 2006).

“The fundamental premise underlying the Internal Revenue Code is that taxation is based upon a transaction’s substance rather than its form. Thus sham transactions are not recognized for tax purposes...” Freytag v. Comm., 904 F.2d 1011, 1015 (5th Cir. 1990). Courts have recognized two basic types of sham transactions: shams in fact and shams in substance. Shams in fact are transactions that never occurred in reality, that is, transactions that have been created on paper but which never took place. Shams in substance are transactions that actually occurred but that lack the substance that their form represents. See ACM Partnership v. Comm., 157 F.3d 231, 247 n.30 (3rd Cir. 1998) (citing Kirchman v. Comm., 862 F.2d 1486, 1492 (11th Cir. 1989); accord Lerman v. Comm., 939 F.2d 44, 49 n.6. (3rd Cir. 1991).

The sham transaction doctrine requires a thorough examination by courts of the challenged transaction as a whole, as well as each step thereof, to determine if the substance of the transaction is consistent with its form. See ACM Partnership, 157 F.3d at 246; Weller v. Comm., 270 F.2d 294, 297 (3rd Cir. 1959). As the Supreme Court stated in Comm. v. Court Holding Co., 324 US 331, 334 (1945):

The transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. * *

* To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

Where a taxpayer has claimed a deduction, that taxpayer bears the burden of proving the economic substance of that transaction. Coltec, 454 F.3d at 1355. Further, as the Coltec court stated:

Gregory v. Helvering requires that a taxpayer carry an unusually heavy burden when he attempts to demonstrate that Congress intended to give favorable tax treatment to the kind of transaction that would never occur absent the motive of tax avoidance.” Id. at 1355-56 (internal quotation marks omitted).]

III. Distortion of Income/Time Value of Money

In United States v. Hughes Properties, Inc., 476 U.S. 593 (1986), the taxpayer owned a gambling casino that had certain slot machines that provided “progressive” jackpots. The amount of each of these jackpots increased over time, based on the amount of usage, until the jackpot was won or a maximum payout amount was reached. At the end of each taxable year, the taxpayer calculated the sum of all of the accumulated but untriggered jackpots and subtracted the corresponding figure that had been computed at the end of the prior year. The average deferral of the jackpots was approximately 4 ½ months. The Supreme Court allowed the taxpayer’s deduction of this amount as an ordinary business expense. The Court stated:

Nothing in this record even intimates that . . . [the taxpayer] used its progressive machines for tax-avoidance purposes. . . . [The taxpayer’s] revenue from progressive slot machines depends on inducing gamblers to play the machines, and, if it sets unreasonably high odds, customers will refuse to play and will gamble elsewhere. Thus, [taxpayer’s] economic self-interest will keep it from setting odds likely to defer payoffs too far into the future. Nor, with Nevada’s strictly imposed controls, was any abuse . . . likely to happen. Id. at 605.]

In Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969), the taxpayer manufactured airplanes, and each purchaser of an airplane received a “Mooney Bond,” redeemable for \$1000 when the airplane was permanently retired from service. Such retirement typically occurred 20 or more years from the date of purchase. Mooney, an accrual taxpayer, attempted to deduct the \$1000 redemption price of the bonds in the year of the sale of the plane. The Service denied the deduction, and the Court of Appeals upheld the denial, emphasizing that the long time period between the deduction for the bonds and their date of redemption was problematic and caused a distortion of income. Id. at 409-10.

Ford Motor Co. v. Comm., 102 T.C. 87 (1994), *affd.* 71 F.3d 209 (6th Cir. 1995), involved a taxpayer that had entered into a number of structured settlements to resolve personal injury and accidental death claims. The settlements provided for payments of approximately \$24.5 million to be made over extended periods, the longest of which was 58 years. The taxpayer purchased for approximately \$4.4 million single premium annuity contracts that would pay the amount of the yearly obligation under the structured settlement over the term of each settlement. Taxpayer remained the owner of the annuity contracts, and it also remained liable to the claimants in the event that the annuity contract issuer defaulted. Taxpayer attempted to currently deduct its entire

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\$24.5 million structured settlement liability in the year that it purchased the annuities. The Court rejected the taxpayer's argument that, under Hughes Properties, it should be entitled to a current deduction. The court stated:

[H]ad the obligation which the taxpayer sought to accrue in Hughes Properties extended to over 58 years, the Commissioner's time value of money concerns would not have been dismissed by the Court. The length of the payout in the instant case causes a gross distortion of petitioner's true economic obligations to the tort claimants. [102 T.C. at 104.]

ANALYSIS

REIT-CO has claimed a current DPD for the entire amount of the putative consent dividends declared on the Class A Preferred Stock in each year at issue. The amounts of such putative consent dividends represent a rate of return in excess of i% on the Class A Shareholder's initial investment. However, the Class A Shareholder is not entitled to and will never receive the economic benefit of a vast majority of these amounts. In fact, REIT-CO has acknowledged that the economic benefit of the putative consent dividends declared will actually be a return of approximately g%. If allowed to stand, REIT-CO's deduction of these amounts, grossly in excess of the economic benefit that will ever be enjoyed by the Class A Shareholder, would allow these amounts to escape current taxation both at the REIT level and to grow tax-free in REIT-CO for the ultimate benefit of the Class B Shareholders. However, because the Class A Shareholder has been allocated dividends that exceed its actual pro rata claim on the earnings of REIT-CO, the entire amount of the dividends declared by REIT-CO constitutes a preferential dividend. Preferential dividends are not considered dividends for purposes of computing the DPD. Therefore, REIT-CO fails to meet the distribution requirements of section 857(a)(1)(A) and fails to qualify as a REIT under federal tax law.

I. Sham Transaction & Substance over Form

Tax treatment of a transaction depends upon "the objective economic realities of a transaction rather than . . . the particular form the parties employed." Boulware, 128 S. Ct. at 1175. For this reason, sham transactions are not recognized for tax purposes. Freytag v. Comm., 904 F.2d at 1015. Courts have recognized two basic types of sham transactions: shams in fact and shams in substance. "Shams in fact" are transactions that never occurred in reality; that is, transactions that have been created on paper but which never took place. "Shams in substance" are transactions that actually occurred but lack the substance that their form represents. ACM Partnership, 157 F.3d at 247 n.30.

The putative consent dividends at issue constitute shams. Reading the controlling documents together and in their entirety, it is clear that the stated dollar amounts of the putative consent dividends would only be paid to the Class A Shareholder if the structuring were to remain in place until the scheduled liquidation

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date of REIT-CO, in Year 66, more than 60 years following the restructuring. However, it is equally clear under the controlling documents that the structuring will not be permitted to reach maturity. Further, even if it were assumed that the structuring would stand until the scheduled liquidation date, the declaration of those putative consent dividends constitutes an economic sham. Because the Class A Shareholder would receive only the stated value of the declared amount, without further earnings, the diminishing value of money over the extended period would ensure that the economic value of the vast majority of such putative consent dividends could never reach the claimed distributee. Thus, the declarations of these amounts do not have the sufficient substance for their form to be respected.

The operative provisions with regard to the restructuring are spread throughout multiple documents that are written in extremely opaque and unnecessarily complex language. The Service acknowledges that the Articles appear to grant to the Class A Shareholder the right to receive any dividends that are declared each year through Year 18, following the payment of dividends on the Senior Preferred Stock and the payment of the \$dd Class B Preferred Dividend to the Class B Shareholder. However, this provision cannot be read in isolation, but must be read in conjunction with the remainder of the transactional provisions. Court Holding, 324 U.S. at 334; ACM Partnership, 157 F.3d at 247.

A thorough reading of the Articles and the Stockholders Agreement as a whole, makes clear that the economic value of the Class A Shareholder's right under the Articles is eviscerated through application of certain provisions in the documents which: (1) grant to the Class A Shareholder an annual cash dividend of \$ee, but require it to accept any further dividends as consent dividends (rather than as cash dividends) through Year 18 (that is, during the Accumulation Phase of the structuring); (2) provide that, once the Accumulation Phase has ended and the Distribution Phase has begun, the Class A shareholder will be entitled only to its Class A Minimum Dividend of approximately \$ee,¹ and the Class B Shareholder will return to its position of entitlement to any residual earnings of REIT-CO; and (3) grant a call and put options on the Class A shares to the Class B Shareholder and the Class A Shareholder, respectively, that provide for unwinds of the structuring to enable either party to take advantage of movements in market interest rates.

"[W]hen the taxpayer claims a deduction, it is the taxpayer who bears the burden of proving that the transaction has economic substance." Coltec, 454 F.3d at 1355-56. Therefore, in order for the restructuring to be respected, REIT-CO must prove that Class B Shareholder, who made a large majority of the capital contributions to REIT-CO, actually ceded to Class A Shareholder, a very small minority investor, its economic rights to a large majority of the earnings of REIT-CO.

¹ This distribution amount may be adjusted upward slightly to provide a small "equity kicker", but even if this were to occur, the Class A Shareholder's actual economic benefit would be nowhere near the i% return that REIT-CO seeks to deduct.

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The controlling documents confirm that Class B Shareholder did not cede to the Class A Shareholder its economic rights to these earnings of REIT-CO. Those documents provide for four potential unwinds of the structuring: a Scheduled Put or Call will be exercised, an Unscheduled Put or Call will be exercised, the REIT-CO option will be exercised, or REIT-CO will liquidate in Year 66. Under any of the unwind provisions, the Class A Shareholder will receive only a nominal portion of the amounts for which it executed a consent.

It is an economic near-certainty that the structuring will unwind through the exercise of one of the options. Once the Accumulation Phase ends, REIT-CO will declare no further putative consent dividends to the Class A Shareholder and the extraordinary tax benefit to REIT-CO and Class B Shareholder ends. Either the Class A or the Class B Shareholder will exercise its Scheduled Put or Call option depending on the state of market interest rates at the time. REIT-CO has assumed that the Class A Shareholder's rate of return will be f to g %. If this rate is above market, the Class B Shareholder will exercise its option because it will have no reason to pay an above-market rate after it has exhausted the tax benefit of the arrangement. Alternatively, if the Class A Shareholder's rate of return is below market, the Class A Shareholder will exercise its option so that it can place its money into a more lucrative arrangement. The tension created by the terms of the scheduled put ensures that one or the other party will exercise its option.

Further, if the Class A Shareholder should attempt to gain access to cash distributions beyond the Class A Minimum Dividends by refusing to execute the required consents, the structuring will unwind. On the occurrence of such a Class A Stockholder Breach Event, REIT-CO would be entitled to exercise the REIT-CO option to acquire the Class A Preferred Stock at a penalty price, which would be lower than the price on the Scheduled Options.

Even if the structuring were to remain in place until the REIT's scheduled liquidation, the Class A Shareholders would not receive the economic benefit that is being currently deducted by REIT-CO. The Articles provide that, under those circumstances, the Class A Shareholder would receive its initial investment plus any remaining assets, which would be the pool of dividends for which the Class A Shareholder executed consents. However, the Class A Shareholder would not receive any earnings on that pool, as all current earnings would be paid out beginning in Year 18. This failure to earn any return on this pool for an extremely large number of years would greatly diminish its value. As discussed above, the Taxpayer has conceded in its Previous Submission that, under the liquidation scenario, the Class A Shareholder would expect to receive its initial investment plus a return of f %. Further, this expected return includes the value of the Class A Minimum Dividend, which is paid annually in cash, and which provides the Class A Shareholder with a return on its initial investment of g %. Therefore, the additional value added by the declaration of the putative consent dividends is g % (f % minus g %).

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Put in its simplest terms, REIT-CO is claiming a current deduction for a dollar amount which, under the most favorable circumstances, will not be paid out for almost 60 years.² These circumstances are very similar to the facts of Ford Motor Co. In Ford, the taxpayer sought to claim a current deduction for amounts that would not be paid for many years to tort claimants under structured settlements, with the longest structured settlement extending 58 years. Under those facts, the Tax Court denied the current deduction, stating that “[t]he length of the payout in the instant case causes a gross distortion of petitioner’s true economic obligations”. 102 T.C. at 97. The court limited the taxpayer’s deduction to an amount that did not exceed the present value of its future obligation to pay. 102 T.C. at 104.

It appears to be uncontestable that, under any of these unwinds, the Class A Shareholder will not receive the economic equivalent of the amounts of putative consent dividends declared. Promoter’s marketing materials provided that the Class A Shareholder’s annual return on investment would fall into the range of ll% (including current cash distributions which themselves provide a return of g%). Further, in its Previous Submission, REIT-CO acknowledged that the parties expected that the Class A Shareholder would receive an annual economic return of f to g% (again, including the value of current cash distributions). These estimates stand in stark contrast to a return in excess of i% that is reflected in the putative consent dividend for which REIT-CO claimed a DPD.

The arrangement was structured so that the Class A Shareholder would make consent dividends on huge amounts of the REIT’s Income through Year 18. This would allow these amounts to escape taxation both at the REIT level and at the shareholder level and to grow tax-free in REIT-CO for the ultimate benefit of the Class B Shareholders. The Class A Shareholder’s economic claim on the earnings of REIT-CO, as determined upon examination of all of the relevant documents, is a return of its investment plus a rate of f to g%. Therefore, the declarations of putative consent dividends of extraordinary returns to the Class A Shareholder in excess of this real entitlement constitute shams that will be disregarded for tax purposes. Tower, 327 U.S. at 291 (Courts do not recognize the “simple expedient of drawing up papers,” as controlling for tax purposes when the objective economic realities are to the contrary).

II. REIT Qualification and Consent Dividend Provisions

Under section 857(a)(1)(A), a corporation will not qualify as a REIT for a taxable year unless it receives a deduction for dividends paid that meets a certain threshold in that year. Under section 561(a), the deduction for dividends paid includes consent dividends for the taxable year (determined under section 565). However, section 565(b) provides that a consent dividend shall not include an amount which if distributed in money would constitute a preferential dividend under section 562(c). Section 562(c)

² As discussed above, the economics of the deal make it extremely likely, if not certain, that one of the options will be exercised before the liquidation date and, thus, that the large majority of the amounts at issue will never be paid to the Class A Shareholder.

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defines a preferential dividend to include any distribution made with preference to one class of stock as compared to another class, except to the extent that the former class is entitled to such preference without reference to waivers of their rights by shareholders. Section 1.565-2(b)(2), example (3) clarifies that a preferential dividend occurs where a shareholder receives more than its pro-rata entitlement of the combined amounts of the actual and the consent dividends. Section 1.565-2(a) provides that a corporation will not be entitled to a DPD in the case of any distribution on a class of stock if there is distributed on such class of stock more or less than the amount to which it is entitled as compared with any other class of stock.

As discussed above, the putative consent dividends declared on the Class A Preferred Stock constitute shams because, under the controlling provisions, read as a whole, the Class A Shareholder will never be entitled to the economic benefit of those amounts. Rather, the Class A Shareholder's entitlement is limited to an annual return of f to g%. Because the putative consent dividends declared constitute an amount substantially in excess of the entitlement of the Class A Preferred Stock, the dividends declared in the years at issue constitute preferential dividends and, under section 565(b), REIT-CO is precluded from taking a DPD for such dividends.

Because REIT-CO may not claim a DPD with regard to the amounts at issue, it fails to meet the requirements of section 857(a)(1)(A) for the taxable years at issue. Therefore, REIT-CO fails to qualify for REIT status under section 857.

III. Conclusion

Because the Class A Shareholder is not entitled to and will never receive the economic benefit of amounts for which it has executed consents, the putative consent dividends declared by REIT-CO are shams. The declaration of such dividends in excess of the actual dividend rights of the Class A Preferred Stock results in the treatment of the putative consent dividends as preferential dividends. Preferential dividends are not treated as consent dividends, and a DPD is not allowed with regard to such amounts. Because REIT-CO is not entitled to a DPD for such amounts, REIT-CO fails to meet the requirements of section 857(a)(1)(A) for taxable years at issue.

Please call (202) 622-7530 if you have any further questions.